

Investment trust companies: next steps

A submission by the Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to comment on HM Treasury's proposals to allow investment trust companies (ITCs) to invest tax-efficiently in bonds and other interest producing assets. These are significant measures which have the potential to lead to major developments in the sector, including the launch of new onshore ITCs and enabling existing companies to change their investment strategies to better meet shareholder needs.

The AIC fully endorses the policy direction adopted by HM Treasury and **recommends** the earliest possible introduction of the regulations designed to implement this policy.

The AIC has reviewed the proposed regulations in detail. This included convening an expert working group of tax and legal advisers to identify adjustments which might be made to the draft regulations to better deliver HM Treasury's desired policy intention.

Our overwhelming conclusion is that the published regulations represent an excellent starting point for introducing the new regime. As a consequence we have very few suggestions as to how they could be improved. Those which we have are of a minor, technical nature. They are set out in the attached Annex.

However, there are other aspects of the ITC regime which should be looked at to allow the regulations to deliver HM Treasury's policy intention earlier and more completely than will otherwise be achieved.

Interaction of the regulations with the 'income test'

Ideally the introduction of regulations allowing investment in interest producing assets would be accompanied by consequential amendments to the 'income test' as set out in section 842 of the Income and Corporation Taxes Act 1988 (ICTA 1988).

The policy objective of reforming the current regime is to allow ITCs to hold a broad range of interest producing assets. HM Treasury has concluded that these assets are suitable for ITC investment. It is also introducing other measures (such as a duty to deduct tax at source from relevant distributions) to ensure the correct tax outcome is achieved vis-à-vis the individual taxpayer and the Exchequer.

HM Treasury's decision to allow ITCs to hold these assets tax-efficiently is consistent with the fact that they are already available to investors in competing

vehicles, such as Authorised Unit Trusts and OEICs which have adopted 'bond fund' status. Successfully introducing these reforms will therefore enhance choice and competition in the investment market while delivering the Government's wider policy objectives in relation to tax. Insofar as the changes bring investment company activity back onshore, they will also support the Government's preferred regulatory arrangements for investment companies. No policy arguments have been advanced for limiting the ability of ITCs to invest in interest producing assets, or delaying making the proposed change as soon as possible, as long as the ITCs concerned are complying with the broader requirements of the regime.

Our concern is that, where a company has opted to comply with the regulations, investment in interest producing assets could result in it losing its ITC status for reasons that are unrelated to the primary policy intention. This arises because the ITC might receive interest income which would fail to meet the underlying requirement for it to receive 70% of its income from 'shares and securities'. This is because some of the assets to be encompassed by the streaming regime are not 'securities' for the purposes of this test.

If a consequential amendment to the income test is not made simultaneously with the introduction of these regulations, we anticipate that existing ITCs may be reluctant to adopt the regime or make significant changes to their investment approach. Guarding against the loss of ITC status is a key priority of an ITC board – a position we anticipate that HM Treasury would fully endorse. Boards will be extremely unwilling to take risks in this area.

In theory the ITC could seek to impose internal controls on its investment approach to prevent a loss of tax status. This could include limits on investing in assets which would not produce eligible income. In reality such an approach is impractical. Precisely which assets are 'securities' for the purposes of this test is uncertain. There is no definition within ICTA 1988, and the definition that is traditionally used in the Taxation of Capital Gains Act 1992 is ambiguous. In the past this has not been an issue, as questions over whether or not a loan instrument is a security have been academic as most ITCs invest predominantly in equities and have very limited investments in loan instruments. They therefore have considerable 'headroom' on the income test, making the question of whether other instruments are securities irrelevant.

However, an ITC wishing to take advantage of the new freedom to invest in interest producing assets is likely to dedicate a substantial proportion of its portfolio (at least 30%) to loan relationships (as defined in the regulations). This would in all likelihood give rise to interest income which accounts for at least 30% of the company's total income (probably more, as loan instruments may have a relatively higher yield than equities). The question of whether these loan relationships are securities will be critical to the success of the regime in the absence of a change to the income test.

To date, the main types of loan relationship instruments which have been confirmed as securities by HMRC are Government issued instruments such as Gilts, Treasury bills etc. In reality eligible instruments would be far wider than this, but any doubt over the tax status of a transaction which threatens section 842 status will have huge commercial ramifications and create significant concerns for an ITC's board. This will be particularly pertinent as ITCs looking to use this regime are likely to want to invest in a variety of assets, including, for example, unquoted debt, where there is no clear precedent as to whether these amount to securities.

These risks and uncertainties would not exist if the ITC were to choose to domicile offshore. This suggests that most ITCs seeking to invest in interest producing assets will continue to launch offshore while any uncertainty persists over the impact that receiving income from assets identified in the regulations might have on meeting section 842 requirements. Existing ITCs would find it difficult to justify changing their asset allocation and entering the regime if their tax status could be jeopardised.

Informal discussions with HM Treasury have indicated that changes to section 842 will be considered separately from the current reform process. We anticipate that this would mean changes being made in Finance Bill 2010 at the earliest. This will mean that the earliest likely take-up of the regime will not occur until some time in 2011. This is unfortunate as market conditions may well favour investment in interest producing assets in advance of the income test being changed and delay what, in policy terms, has been identified as a suitable evolution of the ITC sector. Taking two years to secure the full benefits of streaming will reduce the credit the Government is justified in receiving for making the intended policy change.

We note that HM Treasury has previously adopted the practice of making consequential amendments to section 842 at the same time as broader policy decisions have made this necessary. Indeed, most of these amendments have related to the income test.

For example, when the Government introduced the loan relationships legislation in 1996, one of the central features of the regime was that loan relationship debits and credits were 'netted off' against each other to arrive at an overall taxable/relievable amount. This was inappropriate for the purposes of the income test, as it risked the investment trust seeing its income from securities being reduced or eliminated by its loan relationship debits (e.g. on bank overdrafts, debentures etc). The Government therefore amended the income test (see section 842 (1AB) ICTA 1988) to provide that the income test was tested by reference to income arising on creditor relationships only.

In 2004, the Government decided to reform the tax treatment of management expenses, and provided that a reversal of a management expense could result in income assessable under Schedule D Case VI (see section 75B ICTA 1988). This created a potential problem for ITCs, as this 'income' would not be income from shares and securities. The Government therefore amended the income test (see section 842(1AC) ICTA 1988) to provide that income of this nature would be ignored for the purposes of the income test.

In 2007, a further amendment to the income test was made to address a similar problem in relation to offshore income gains (see section 842 (3A) ICTA 1988). A further consequential amendment to the income test is being provided for this year as a result of changes to the offshore funds regime. We also believe that a reform to the income test may be required as a result of the proposals in relation to the foreign profits reform.

There is therefore a considerable precedent for the Government making consequential amendments to the income test as a result of general reforms of company taxation. It is therefore surprising that a reform which is specifically targeted at ITCs should not benefit from a similar consequential amendment, especially as changes to the income test are already planned in connection with other tax reforms.

While we understand that space in the Finance Bill and the resources available to HM Treasury to draft such changes are limited, we believe that the amendment required would be relatively straightforward. For example, the income test might be amended so that "relevant credits", as defined in Regulation 8(2), are automatically included in income derived from shares and securities.

If the necessary changes to the income test cannot be made in the current Finance Bill we would support a two-stage process. However, we **recommend** that changes to the income test be considered now so that ITCs can enter the new regime at the earliest possible opportunity.

We are aware that HM Treasury is considering how it can more generally modernise the legislation underpinning the ITC regime. We have had, for example, very constructive discussions with officials regarding moving the rules into regulation, which would make future adjustments to the regime more practical.

We have also been encouraged by conversations relating to the tax law re-write project and the possibility of introducing a minor and/or inadvertent breach provision for ITCs (although we recognise that none of these matters have yet moved to the status of formal policy intentions).

We should emphasise that we regard changes of this nature to be a broader project that will require a separate policy discussion and could not be introduced

in the timeframe discussed above. However, we feel that a targeted change to the income test to deliver the policy intention of the proposed regulations is a different matter, in the nature of a consequential amendment, and therefore hope this change can be expedited in advance of any wider changes.

In the event that the proposed amendment cannot be made simultaneously with the introduction of the regulations, we **recommend** other measures be adopted to ameliorate potential problems. While other actions would not be as complete or effective as a legislative change, they could be helpful in allowing the sector to capture the broadest benefits of the regulations as early as possible.

With this in mind, we **recommend** that HMRC should consider introducing a pre-approval process which would allow managers to seek assurance from HMRC over whether or not income received from a specific investment would amount to income from a security for the purposes of the income test. This process should allow a manager to get this assurance before a transaction is conducted. This would provide the necessary certainty for the ITC. However, it would be important that such approvals were provided in a timely manner to ensure that the commercial activities of the ITC were not inhibited.

We would also **recommend** that HMRC should consider providing detailed guidance on what constitutes a security. Making such guidance robust enough to provide sufficient certainty for ITCs will be challenging given ITCs risk aversion where possible threats to their tax status are concerned. Nevertheless, further clarification in this area would undoubtedly be helpful in the absence of an adjustment to the income test.

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Annex: Detailed comments on the proposed regulations

Qualifying interest income: Reg 8 (2) (b) (i) and (ii) refer to derivative contracts and contracts for differences which consist “wholly” of assets representing loan relationships or currency (in relation to derivatives) and interest rates, creditworthiness and currency (in relation to contracts for difference). We are cautious about the use of the term “wholly” as there may be assets which do not fit this description, but would otherwise be acceptable investments from a policy perspective. Given this we **recommend** this wording could be qualified to read “*wholly or mainly*” (amendment emphasised). This would maximise the flexibility of the regime without creating policy concerns.

Effect of paying interest distribution: investment trust: A question arises as to how the regulations interact with the way in which interest distributions will be accounted for by an ITC which has opted into the regime. Although this distribution will be treated as the payment of interest for tax purposes, it will remain a dividend for company law purposes.

Final dividends will normally be approved by shareholders and paid sometime after the end of the period of account. In addition, under IFRS / UK GAAP, this final dividend will be accounted for in the accounts of the company in which it is paid (i.e. the accounts following the period in which the interest income arises). Clearly, to make the streaming regime work, it is essential that the interest distribution gives rise to a tax deduction in the accounting period in which the taxable interest income arises, and out of which the interest distribution is being paid, not the accounting period in which the interest distribution is paid.

We are therefore keen to confirm that an investment trust is able, under the regulations, to treat a final interest distribution as deductible for tax purposes in the accounting period to which the distribution relates, rather than the period in which it is paid. We believe that the regulations may currently permit this (as the regulations refer to interest distributions “in respect of the period of account”, rather than “paid in the period of account”).

However, given the importance of this issue to the operation of the regime, if there is any doubt that this is possible under the regime, we **recommend** that the regulations are amended to clarify the position.

Drafting amendment: We would note that regulation 14(2) refers to “the obligation specified in paragraph 3”. However, paragraph 3 does not contain any such obligation. We **recommend** that this reference be corrected.